

**NATIONAL RESERVE BANK
OF TONGA**

Monetary Policy Statement
August 2015

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Overview

Recent Developments

Since the last Monetary Policy Statement (MPS), activities in the real sector have generally improved in 2014/15. This supports the National Reserve Bank of Tonga's (NRBT) estimate of 2.5% growth in Real Gross Domestic Product (GDP) in 2014/15, compared to a 2.0% growth in 2013/14 as released by the Department of Statistics, and higher than the 2.2% growth estimate in the February 2015 MPS. The upgrade in the 2014/15 growth estimate is mainly driven by improved growth in the secondary and tertiary sectors due to major events in mid-2015 such as the coronation, school reunions and church conferences, outweighing the continued negative growth in the primary sector. Consumer prices decreased over the year to August 2015 by 1.1%, in line with the deflation rate recorded in February 2015. The lower global energy and food prices contributed to the fourth month deflation since February 2015.

Gross official foreign reserves increased significantly over the past six months, reaching a new record high of \$310.9 million by August 2015. Lower net current account deficit, receipt of foreign aid and Government budget support from development partners, and increase in remittances were the main reasons for this increase. Foreign Reserves as a ratio of imports have remained high at 8.6 months at the end of August 2015, well above the NRBT's minimum range of 3-4 months. The Nominal Effective Exchange Rate (NEER) and the Real Effective Exchange Rate (REER) both declined over the six months to August 2015 due mainly to the general depreciation of the Tongan Pa'anga against currencies of its major trading partners and Tonga's lower inflation. This indicates an improvement in Tonga's price competitiveness against that of its major trading partners.

Tonga's financial system remains sound as the banking system continued to be profitable with strong liquidity and capital position maintained. Monetary conditions improved as total credit and deposits continued to grow, and the banks maintained narrow weighted average interest rate spreads. Broad money increased to its highest level, consistent with the high banking system liquidity.

Net credit to government increased by 11% in the six months to August 2015, after declining by 5% in the six months to February 2015. This reflects a fall in government's deposits due mainly to the settlement of the Government's end-of-year obligations.

Outlook

Looking forward, the NRBT anticipates strong growth of 3.3% for 2015/16, an upward revision from the estimated growth of 3.2% in the February 2015 MPS. This is supported by a rebound in primary production, particularly the agricultural and fisheries sectors.

Headline inflation will continue to remain relatively low until the end of this calendar year supported by the declining global oil prices and low imported food prices.

The NRBT expects a high level of foreign reserves to be maintained in the near term, well above the NRBT minimum range of 3 – 4 months of import cover. Remittances are anticipated to remain high, though may be slightly lower than that of the previous six months after the coronation festivities.

Broad money is expected to increase by about 5% in the 2015/16 financial year. This is mainly due to an expected pickup in domestic credit and the foreign reserves. Currency in circulation is also expected to rise as a result of strong demand for the new currency that was launched in July 2015 and the expected stronger economic activity, partially offset by the recall of the old currency. Credit growth is expected to grow by more than 10% in the next six months, supported by the continuous improvements in business confidence and lending conditions and the high liquidity. Continued competition amongst banks, the high liquidity, and the ongoing lending activities of the Government's Managed Funds will continue to support the current low lending rates.

Government receipt is expected to increase in the near term from budget support, issuance of government bonds and other new revenue streams. These are to finance the overall net borrowing requirement of \$20.7 million for the 2015/16 fiscal year, as reflected in the Ministry of Finance and National Planning's 2015/16 Budget Statement. The NRBT will closely monitor the implication of fiscal policy measures on the monetary policy objectives.

Given the above developments and outlook, the current accommodative Monetary Policy stance is maintained to continue to support macroeconomic stability and economic growth.



Sione Ngongo Kioa
Governor

1. Global Developments

World Growth

Global growth for 2015 is estimated by the International Monetary Fund (IMF) in its October 2015 World Economic Outlook (WEO) to remain moderate at 3.1% although slightly lower than its previous estimate of 3.5% growth in April 2015. This reflects weaker prospects for some large emerging market economies, including China, and oil-exporting countries, as well as longer-term factors such as weak productivity gains. However, global growth is projected to improve in 2016 to 3.6%, reflecting stronger performance in both emerging market and advanced economies.

World Oil Prices

World oil prices have declined sharply over the year to August 2015 by more than 40% to approximately US\$50 a barrel. This is the lowest level since 2009, after a five year period of stable price levels. In Pa'anga terms, this translated to a 35% decrease in domestic oil prices. The world-wide decline in oil prices was due to a combination of factors including low demand due to weak economic activity and Middle East exporters competing for market share with U.S. oil producers, increasing stockpiles thus resulting in a huge oversupply. Although lower oil prices benefitted oil importing countries, this also contributed to weaker growth for oil exporting countries.

Advanced Economies

Economic growth in the United States is weaker than expected after WEO downgraded its growth estimate for 2015 to 2.6% from its last estimate of 3.1%. This reflected setbacks to activity caused by one-off factors, notably harsh winter weather, as well as much lower capital spending in the oil sector.

However, the unemployment rate improved to 5.3% in 2015 compared with 5.5% in its April 15 estimate and 6.2% in 2014. Annual inflation in 2015 is projected at around 0.1% in 2015 after a sharp decline in late 2014 and early 2015 reflecting lower energy prices.

Macro-economic indicators suggested that economic growth in China slowed to 6.8% in 2015 compared to a 7.3% growth in 2014. This reflected a decline in imports and investment compared to the previous year, however consumption growth remained steady as consumer confidence was maintained. While exports were also weaker than expected, they declined less than imports, resulting in net exports contributing positively to growth. Economic growth is projected to slow further to 6.3% in 2016 as the country struggles with its shift from export- to consumption-driven economy. Headline inflation was at 2.0% in 2014 and is forecasted to decrease to 1.5% in 2015 reflecting weak domestic demand and lower commodity prices.

Economic growth for the euro zone countries is projected to rise modestly in 2015–16 with the region benefitting from lower oil prices. However, GDP contraction in Russia as a result of high corporate debt exerts economic pressures in the euro zone. Headline inflation is projected to remain low at 0.2% in 2015, slightly lower than it was in 2014. This reflected a modest recovery in economic activity, the partial reversal in oil prices, and the impact of the depreciation of the euro.

Growth in the Japanese economy is anticipated to increase to 0.6% in 2015 compared to a negative growth of 0.1% in 2014. The gradual pickup reflects implemented monetary policy aimed at stimulating growth via increased money supply, as well as lower

Table 1: World Data (Real GDP Growth, Inflation, and Unemployment)

	Real GDP growth (%)			Inflation (%)			Unemployment* (%)		
	2014	2015 ^f	2016 ^f	2014	2015 ^f	2016 ^f	2014	2015 ^f	2016 ^f
New Zealand	3.3	2.2	2.4	1.2	0.2	1.5	5.7	5.8	5.8
Australia	2.7	2.4	2.9	2.5	1.8	2.6	6.1	6.3	6.2
United States	2.4	2.6	2.8	1.6	0.1	1.1	6.2	5.3	4.9
China	7.3	6.8	6.3	2.0	1.5	1.8	4.1	4.1	4.1
Japan	-0.1	0.6	1.0	2.7	0.7	0.4	3.6	3.5	3.5
Euro Area	0.9	1.5	1.6	0.4	0.2	1.0	11.6	11.0	10.5

Note: f – forecast; * for month of December

oil and other commodity prices. However, headline inflation remained low in 2015 at 0.7% compared to 2.6% in 2014.

Economic growth in the Australian economy is projected to be 2.4% in 2015, below the previous estimate of 2.8%. This is slightly lower than the 2.7% growth in 2014 reflecting an end in mining boom and the slowdown in the Chinese economy, Australia's largest trading partner. However, the economy is projected to grow further by 2.9% in 2016 as a result of large mining resources expected to attract investors, and an increase in private consumption and household savings. Unemployment rate remained at around 6% in 2015 and it is expected to improve in the near term depending on the recovery in China. The Reserve Bank of Australia (RBA) has kept the official interest rate on hold at the record low level of 2% but the accompanying statement shed very little light on the RBA's future intentions. Headline inflation was slightly higher than expected at 2.5% in 2014 compared to WEO's April 2015 estimate of 1.7% and is expected to be lower in 2015 at 1.8%, reflecting lower commodity prices.

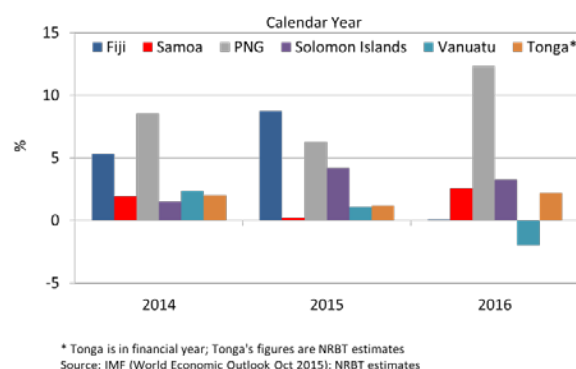
The New Zealand economy is expected to slow to a growth of 2.2% in 2015 before increasing to 2.4% in 2016, reflecting an increase in consumer and business confidence. Further monetary easing has not been ruled out due to lingering concerns about the economy. However, economic slowdown in China could lead to more rate cuts. Inflation is benign

at 1.2% and is expected to decrease to 0.2% in 2015 before rising to 1.5% in 2016.

South Pacific Economies

All the economies in the South Pacific are forecasted to record positive growth in 2015, except Vanuatu. Papua New Guinea's economy grew the fastest by 12.3%, supported by the production of liquefied natural gas. The South Pacific economies have been benefitting from the declining global oil prices which is expected to contribute to growth in all the South Pacific economies in 2015 and 2016 except for Vanuatu. Fiji's economic growth remains subdued in 2015-16 while the devastation of Cyclone Pam is still evident in Vanuatu.

Figure 1: Real GDP Growth Projection



IMF expects inflation in the South Pacific region to generally rise in 2015 before easing in 2016 supported by the expected decline in world oil prices.

2. Tonga's Economic Growth

Real GDP Growth

Since the last Monetary Policy Statement (MPS), the Department of Statistics released the official growth rate for 2013/14. Real GDP is estimated to have grown by 2.0%.

The NRBT estimated real GDP growth of 2.5% for 2014/15, which is supported by the general improvement in activities in the real sector. This is an upward revision from the estimated 2.2% growth released in the February 2015 MPS. The upgrade in the NRBT's growth estimate is mainly driven by improved growth in the secondary and tertiary sectors largely reflecting the implications of the major

events in mid-2015 such as the coronation, school reunions and church conferences, which outweighed the continued negative growth in the primary sectors. This was a result of El Niño weather conditions affecting agricultural supply over the year. Additionally, major construction projects which have been delayed or put on hold largely affected overall economic growth. Looking forward, the NRBT anticipates stronger growth for 2015/16 of 3.3% an upward revision from the estimated growth of 3.2% in the February 2015 MPS. This is supported by a rebound in primary production, particularly the agricultural and fisheries sectors as well as expected developments in the construction sector.

Table 2: Real GDP Growth Forecast

	Official Jun-14	Jun-15 (Feb-15 MPS) %	Jun-15 (Revised) %	Jun-16 (Feb-15 MPS) %	Jun-16 (Revised) %
GDP	2.0	2.2	2.5	3.2	3.3
Primary production	3.1	-2.3	-2.4	2.1	2.1
Agriculture	4.7	-3.0	-3.0	2.0	2.0
Forestry	4.3	0.0	0.0	2.0	1.0
Fishing	-5.9	1.0	1.0	3.0	3.0
Secondary production	1.3	6.9	5.5	5.3	5.4
Mining and quarrying	3.2	5.0	4.0	2.5	3.0
Manufacturing	0.0	3.0	3.0	3.0	3.0
Utilities	-1.2	3.0	5.0	3.5	3.5
Construction	3.4	10.0	8.0	7.0	8.0
Tertiary production	1.6	2.8	3.4	3.3	3.3
Trade	1.1	4.0	5.0	4.0	4.0
Hotels, restaurants	-0.4	5.0	5.0	5.0	5.0
Transport, communication	0.6	5.0	5.0	5.0	5.0
Financial intermediation	4.6	4.0	6.2	5.0	6.0
Real estate, business services	1.5	3.0	3.0	3.0	3.0
Public administration	0.4	2.0	2.0	1.5	2.0
Education	12.0	2.0	2.0	2.0	2.0
Health and social work	8.3	1.0	1.0	1.0	1.0
Recreational, cultural activities	1.4	1.5	1.5	2.0	2.0
Other community services	2.0	1.0	2.0	1.0	2.0
Ownership of dwellings	0.4	0.1	1.5	3.0	2.0
Other*	4.1	1.0	1.0	1.5	1.5

* Includes taxes minus subsidies and imputed bank service charges

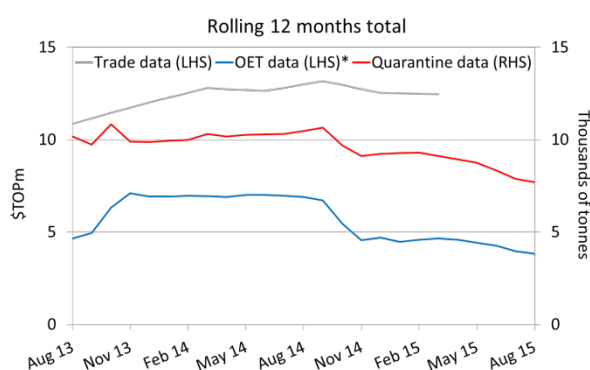
Source: Department of Statistics, NRBT

Primary Production

The total volume of agricultural exports declined by 26.4% over the year to August 2015, which supports the estimated contraction in the growth of the agricultural sector in 2014/15. Various growers have indicated through the NRBT's liaison program that the El Niño weather conditions greatly affected overall production for the sector. Despite increases in products such as sandalwood and vanilla, this was offset by significant decreases in major exports of squash, coconut, and main root vegetable crops. Consequently, the sector is expected to decline further affecting the overall performance of primary production.

Nonetheless, agricultural production is expected to improve in 2015/16. Growers expect better weather conditions as well as harvesting seasons for major exports such as squash to commence. The Government's managed fund loan scheme should also support growth by improving financial access to capital and machinery goods. Training programs carried out by various bodies (including non-profit organizations) aimed at developing primary production should increase interest thus lead to further growth. The establishment of a sector plan supported by the Agricultural Growth Committee is also expected to help with growth in the sector. Uncertainty in weather conditions poses the most significant risk to the outlook of the sector.

Figure 2: Total Agricultural Exports



* Excludes all agricultural receipts that are channeled through foreign exchange dealers.
Sources: NRBT, Ministry of Agriculture, Forestry, Food and Fisheries, Tonga Department of Statistics

The fisheries sector continued to experience moderate growth in 2014/15, unchanged from the previous estimate of 1.0%, a turnaround from an estimated contraction of 5.9% in 2013/14. Fishing companies have indicated that despite gaining more fishing vessels, the El Niño weather conditions have affected sea temperatures thus slowing catch rates.

However, the fisheries sector is expected to experience more growth in 2015/16 due to expectations of improved weather conditions and arrival of new fishing vessels.

The initial expectation for growth in the forestry sector stated in the February 2015 MPS for 2014/15 remains unchanged. However, for 2015/16, the anticipated rise in public and private construction works and the recent increase in sandalwood exports are expected to support growth in the sector.

Secondary Production

The Ha'apai Reconstruction has undergone further delays due to legal issues and other factors which must be addressed prior to the release of further funds for the project. Liaisons with construction companies indicate that they expect the project will continue for at least another year. Further delays to completion dates of large projects including the St. George Palace and Retirement Fund Board building resulted in a downward revision for the construction sector in 2014/15. The sector is now expected to grow by 8.0%, lower than the initial 10.0% stated in the February 2015 MPS. However, construction companies continue to expect a growing number of both public and private projects. Specifically the St. George Palace, Latter Day Saints (LDS) chapel in Fangaloto, Central Police Station, Fuaa Wharf, and other major projects are expected to drive further growth in the upcoming year. The renovation of the International Dateline Hotel (by the Tanoa Group) is also expected to benefit the sector as well as other sectors, including the trade, hotels and restaurants, and tourism. Preparations of infrastructures for the 2019 South Pacific Games are expected to begin by tendering of projects such as the Teufaiva Stadium renovation. As a result, for 2015/16, growth in the sector has been upgraded to 8.0% from 7.0% in the February 2015 MPS.

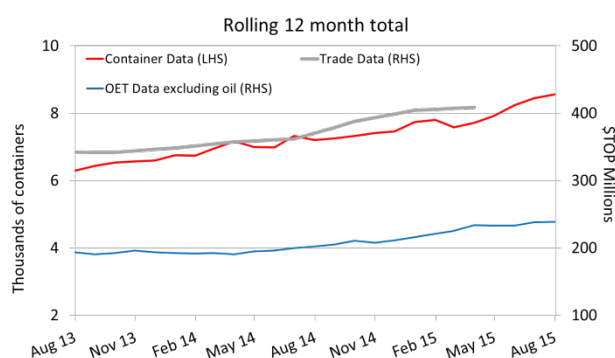
The developments in the construction sector are anticipated to contribute to growth in the mining and quarrying, manufacturing, and utilities sectors. Furthermore, the utilities sector is also expected to benefit from a number of projects such as the Tonga Village Upgrade Network Project, the Ha'apai Recovery Project, and other renewable energy projects. Evidently, data from the Tonga Power Limited (TPL) has shown an increase in the number of consumers and resulting increase in electricity

consumption and production. This led to an upward revision of growth for the utilities sector to 5.0% from the initial 3.0% estimate. For 2015/16, the anticipated growth of 3.5% remains unchanged from the February 2015 MPS.

Tertiary Production

In 2014/15, the trade sector is expected to record strong growth as evidenced by positive partial indicators such as imports volume and import payments which both increased. This could coincide with preparations for the scheduled events around mid-year such as the coronation, church conferences, and other celebrations. Container registrations also recorded its highest level at the end of 2014/15. Therefore, there has been an upward revision to the growth estimate for the trade sector of 5.0% for 2014/15 from the last estimate of 4%. On the outlook, the sector is expected to grow steadily, with no change to the forecast for 2015/16 in the February 2015 MPS.

Figure 3: Import Indicators



Sources: NRBT; Banking System, Foreign Exchange Dealers, Statistics Department, Tonga Ports Authority

Credit growth has risen over 2014/15 with some partial contribution from the Government's managed fund loan scheme. This has led to an upward revision of the growth in the financial intermediation sector to 6.2%, up from the last forecast of 4.0% in the February 2015 MPS. On the outlook, the takeover of the Westpac Bank of Tonga by Bank of

South Pacific and improvements to the credit environment such as the passing of the Receivership law is expected to promote easier access to finance which could likely drive further growth in 2015/16. Most recent data also indicates that credit growth has increased so far for 2015/16 and is expected to continue with some pipeline bankable projects. Therefore, growth for the financial intermediation sector has been revised up to 6.0% in 2015/16 from the last estimate of 5.0%. However, the Government's newly introduced foreign exchange levy and de-risking by banks pose a significant risk to the growth of this sector.

The tourism sector is expected to grow in 2014/15 underpinned by major events held over the year. Looking forward, the establishment of a Ministry for this sector alone in the 2015/16 financial year in addition to tourism projects supports further growth. However, the proposed increase in departure tax in the Government's 2015/16 Budget Statement poses a risk to the growth outlook for the sector.

The return of declining global oil prices in 2015/16 is expected to have a positive effect on transportation and travel costs. This is further supported by vehicle registrations which increased by 32.0% over the year to August 2015.

Unemployment

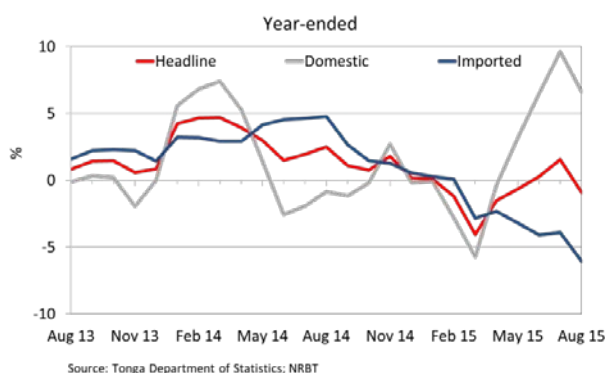
There has not been any further update of the unemployment rate from the last Monetary Policy Statement, which was last reported at 6.5%. The NRBT continues to investigate new avenues for the production of more timely labor market data. Recently, job advertisements posted in local media show an upward trend over the six months to August 2015. Despite this being a partial indicator for unemployment, it also shows the capacity for employment. The finalization of the outcome of the agricultural census may also provide some indication of the unemployment level.

3. Promoting Low and Stable Inflation

Recent Developments

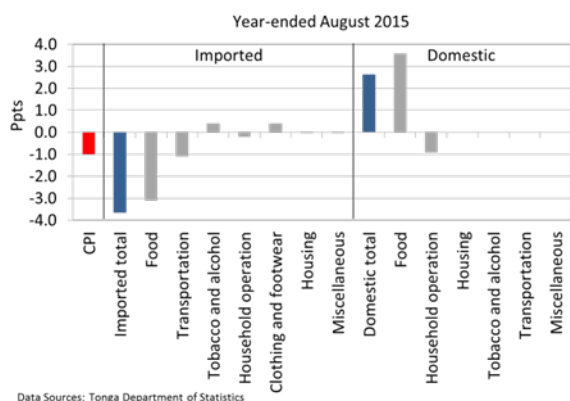
Consumer prices decreased over the year to August 2015 by 1.1%, similar to the deflation rate recorded in the February 2015 MPS, largely as a result of lower global energy and food prices. This is the fourth deflation since February 2015.

Figure 4: Inflation



Imported inflation declined by 6.0% driving the general decrease in consumer prices. Specifically, imported food prices decreased for all food items except Dairy products and Other food. The decline in global oil prices resulted in lower domestic energy prices and lower Transportation and Household Operations components. The depreciation of the Tongan Pa'anga against the U.S. Dollar could have partially offset the effect of falling global oil prices on the Transportation component.

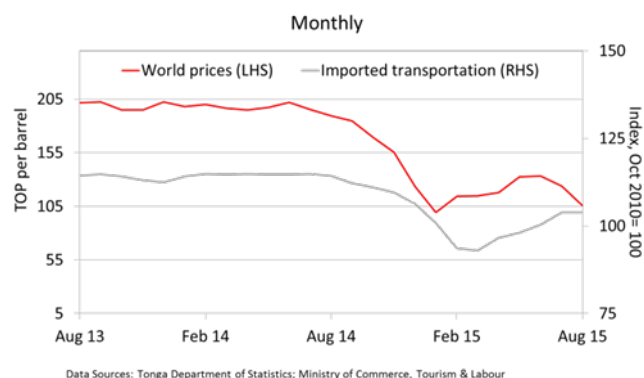
Figure 5: Contributions to Inflation



In contrast, Domestic inflation increased by 6.6% over the year. This was driven by higher Food prices for items such as Fruit & vegetables, and Meats, fish & poultry. This could have been due to the El Niño

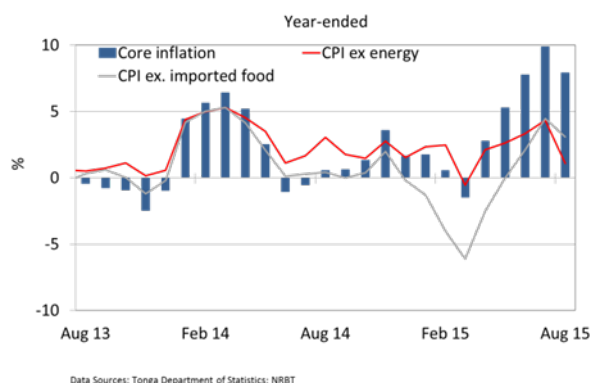
Weather conditions over the year affecting agricultural output. Additionally, there could have been higher demand in comparison to the previous year, due to scheduled church conferences, coronation festivities, and other special events that took place during the year.

Figure 6: World Oil Prices



The core inflation rate (excludes imported food and imported energy prices) increased by 7.9% over the year to August 2015. In comparison to the 0.6% rise recorded over the year to February, this large increase indicates the significant influence of recent movements in global prices on inflation.

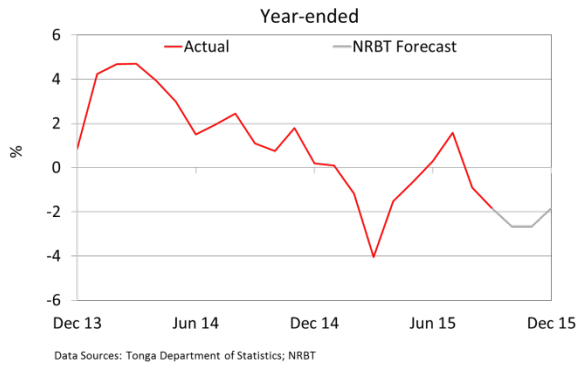
Figure 7: Alternative Inflation Measures



Outlook

Similar to the last forecast in the February 2015 MPS, the NRBT projects that headline inflation will continue to remain relatively low until the end of this calendar year. This is supported by the declining global oil prices and low imported food prices.

Figure 8: Headline Inflation

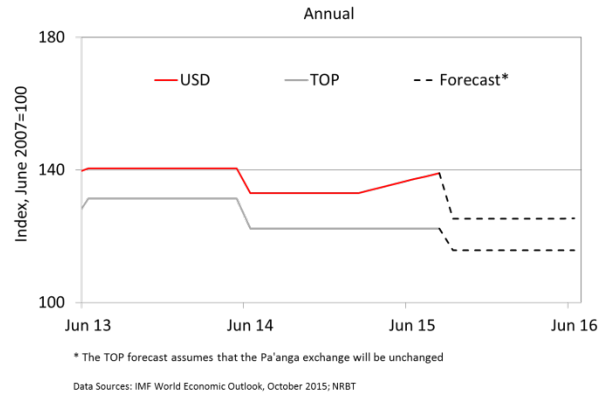


Note: The actual inflation rate for September 2015 has been included

The forecast is based on three key factors:

- The IMF expects world food prices to be about 16% lower over calendar year 2015, owing to an increase in world food supply.
- Market economists expect world oil prices to remain low for the next six months before prices begin to rebalance and return to normal. Therefore, from the current Crude price (August) of USD\$50 per barrel, they

Figure 9: World Food Prices



expect this to continue declining to as low as USD\$44 per barrel.

- Exchange rates are assumed to be unchanged.

Global economic uncertainties, weather patterns and other factors such as world oil supply, pose a large risk to the inflation outlook.

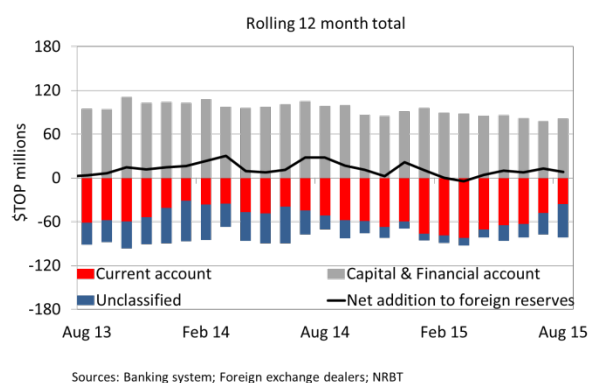
4. Maintaining Adequate Level of Foreign Reserves

The classification of Overseas Exchange Transactions (OET) data has changed following Tonga's transition in September 2015 into the Balance of Payments and International Investment Position Manual 6 (BPM6), endorsed by the International Monetary Fund (IMF). This has resulted in revisions to data since May 2014 causing slight revisions compared to previous publications.

Balance of Overseas Exchange Transactions

The balance of OET was a surplus of \$26.9 million over the year to August 2015, which is 2.8% lower than that of August 2014. The lower surplus reflected lower net capital inflows.

Figure 10: Balance of Overseas Exchange Transactions



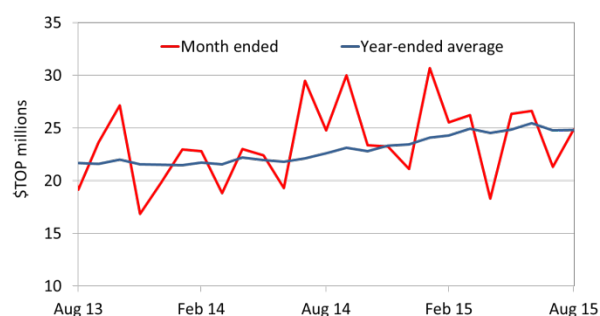
Current Account

Import payments fell by 5.7% to \$144.2 million in the past six months to August 2015. This was driven by an 18.3% decline in oil payments largely reflecting the lower global oil prices. Payments for imports of wholesale and retail goods, however, increased by 10.8% reflecting higher domestic demand which can be attributed to an 18.1% rise in remittances and growth in household loans over the same period. Import of construction materials also rose by 39.1% reflecting the increase in the number of construction activities. Payments for vehicles also rose by 47.3% which coincides with the 54.3% increase in number of vehicle registrations. The rise in import payments is supported by a pick-up in container registrations.

On an annual basis, import payments rose by 11.1% to \$297.0 million in August 2015 due to a significant increase in payments for construction materials which rose by 138%, wholesale and retail goods by

15.5% and vehicle payments by 19.0%. Oil import payments however declined by 15.0% over the year.

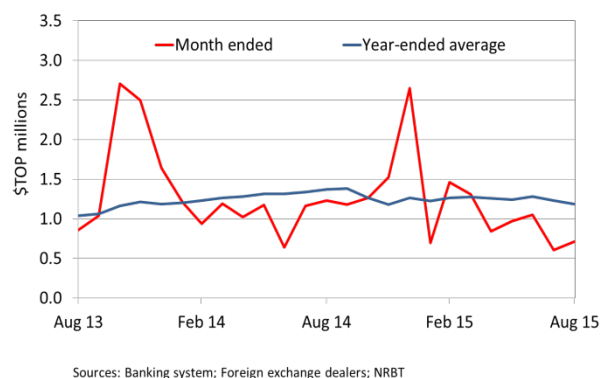
Figure 11: Import Payments



In the six months to August 2015, total export receipts fell by 40.1% when compared to the six months to February 2015. The slowdown in exports is largely attributed to agricultural exports proceeds declining by 68%. This also coincides with a 4.6% fall in agricultural volume over the same period due to an 11.6% fall in root vegetable products and the end of the squash season. In contrast, fish and other marine exports proceeds rose by 13.5% over the six months to August 2015.

Over the year ended August 2015, total export proceeds fell by 10.9%. The annual decrease coincides with a 33.8% drop in agricultural export proceeds and agricultural volumes falling by 26.4% as outlined above. The proceeds from the exports of fish and other marine products, on the other hand, increased by 32.4% over the year.

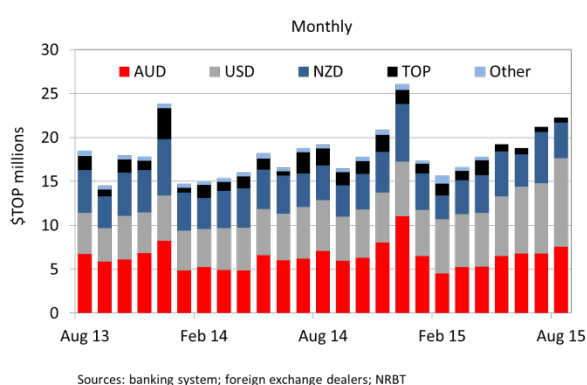
Figure 12: Export Receipts



Travel receipts over the six months to August 2015 were around \$40 million, an increase of 15.9% compared to the past six months to February 2015. This is supported by a 3.3% rise in international arrivals, mainly due to coronation festivities, school reunions and annual church conferences. Over the year to August 2015, travel receipts slightly declined by 0.5%.

Remittances rose by 18.1% over the six months to August 2015, recording \$116.4 million. The strong US dollar (USD) supported a 34.5% rise in remittances received in USD which totaled to over \$40 million.

Figure 13: Remittances



In year ended terms, remittances remained at high levels, totalling \$215.1 million for the year ended August 2015, a 6.3% increase from the previous year. This is primarily due to a change in methodology for calculating remittances following Tonga's transition into the BPM6. The largest share of remittances, 36%, came from the US followed by 35% from Australia and 23% flowing from New Zealand. Positive growth in these economies and the weaker Tongan pa'anga contributed to the rise. Remittances as a share of GDP are around 26% as at June 2015.

Over the year to August 2015, the current account balance recorded a deficit of \$36.2 million, narrowing by \$14 million from the deficit recorded in the previous year. This was the result of increases in transfers and services receipts which more than offset the rise in merchandise trade payments.

Capital Account

Capital inflows fell by 48.0% to around \$7.6 million over the past six months to August 2015. This was

due to lower private capital receipts, mainly in the form of interbank transfers, which more than offset a rise in official capital receipts. Capital payments however rose significantly over the same period from less than a million to over \$3 million driven by higher private capital payments. Therefore, net capital account balance recorded a surplus of \$4.4 million over the six months to August.

In year ended terms, the net capital account balance was a surplus of \$18.3 million, 40.1% lower than over the year to August 2014. The lower surplus reflected a fall in private capital receipts.

Financial Account

Financial inflows rose by 17.0% to around \$52.0 million over the past six months to August 2015. This was due to the increase in Tongan residents transferring money from their bank accounts overseas to domestic bank accounts. Financial outflows also rose by 6.0% over the same period to \$18.0 million driven by higher loan repayments by residents to non-resident banks. Therefore, the net financial account balance was a surplus of \$34.7 million over the six months to August 2015.

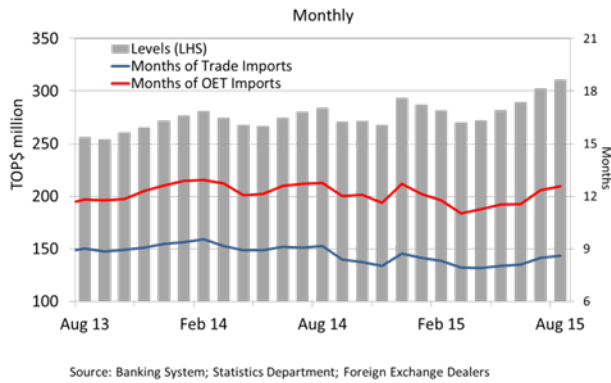
Over the year ended August 2015, the net financial account balance was a surplus of \$62.8 million, 5.3% lower than over the year to August 2014. The lower surplus reflected a fall in direct investment.

The balance of unclassified transactions was an average outflow of \$1.5 million per month over the year ended August 2015 slightly lower than the balance over the same period last year. The lower number of unclassified transactions reflects better coverage and classification of OET data.

Official Foreign Reserves

Gross official foreign reserves increased significantly over the past six months, reaching a new record high of \$310.9 million at the end of August 2015. Lower net current account deficit, receipt of foreign aid from development partners including budgetary support for the Government, and increase in remittances contributed to the higher foreign reserves over the past six months. Foreign Reserves when measured as a ratio of imports have remained high at 8.6 months of import cover at the end of August 2015, well above the NRBT's minimum range of 3-4 months.

Figure 14: Gross Official Foreign Reserves



Exchange Rates

The Nominal Effective Exchange Rate (NEER) fell by 1.6% over the six months to August 2015 following the Tongan Pa'anga depreciating against currencies of its major trading partners except the New Zealand dollar. The fall in prices combined with the depreciation in the NEER accounted for the 2.6% decline in the Real Effective Exchange Rate (REER). The lower REER indicates an improvement in

Tonga's price competitiveness against that of its major trading partners.

Outlook

The NRBT expects the level of foreign reserves to remain high in the near term. The forecast stems from a balance of key factors:

- The trade balance is expected to deteriorate with higher imports being fuelled by firmer lending outcomes.
- Remittances are anticipated to remain high though may be lower than that of the previous six months after coronation festivities.
- Budget support from donor partners will continue to be received, although the timing will pose a risk to the outlook.

The Foreign Exchange Levy on all receipts and payments and the pace of development in domestic economic activities may pose a risk to the foreign reserves outlook.

5. Promoting a Stable Financial System

Tonga's financial system remains sound as the banking system continued to be profitable with strong liquidity and capital positions being maintained. Monetary conditions improved as total credit and deposits continued to grow, and narrow weighted average interest rate spreads remains. Consistent with the high banking system liquidity, broad money increased to its highest level and foreign reserves remained well above the minimum range.

Money Supply

Broad money grew by 11.7% to \$424.2 million over the 6 months to August 2015, compared to a 4.0% growth over the six months to August 2014. This is the highest level by the standard of the past decades, which is in line with the record levels of foreign reserves coupled with the improved credit growth rates. The growth in broad money was fueled by a 13.4% increase in net foreign assets and an 8% rise net domestic assets. The increase in foreign reserves drove the rise in net foreign assets while the high net domestic assets resulted from a rise in banks' lending. Broad money also increased over the year by 15.5%, resulting from a 32.3% increase in net domestic assets and a 9.9% rise in net foreign assets. An increase in currency in circulation, which indicates a more active domestic economy, and savings and term deposits also contributed to the rise in broad money.

Liquidity in the banking system rose by 11.5% over the past six months, reaching its highest level of \$167.2 million. Banks' liquidity also increased over the year by 12.4%. The rise is attributed mainly to the higher foreign reserves and banks' deposits.

Interest Rates

The weighted average interest rate spread slightly narrowed to 6.0% in August 2015 from 6.2% in February 2015. This was due to a 17.2 basis points decline in the weighted average lending rate to 8.29%, and a 0.8 basis points fall in the weighted average deposit rate. Increased competition amongst banks while the liquidity in the banking system remains at high levels, has supported the lower weighted average interest rate spread. Over the year, the weighted average interest rate spread has narrowed from 7.83%.

Figure 15: Interest rates spread

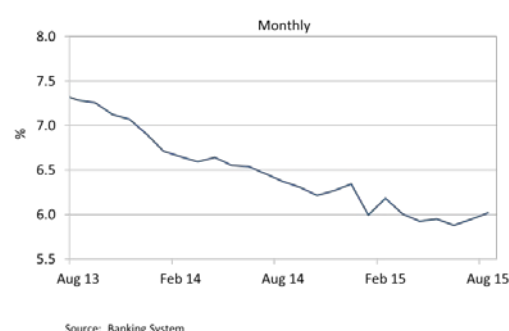


Table 3: Consolidated Balance Sheet of Depository Corporations

	Level			YoY change	
	Aug 15 \$TOPm	Feb 15 \$TOPm	Aug 14 \$TOPm	Aug 15 \$TOPm	%
Broad money liabilities	424.2	379.7	367.3	57.0	15.5
Currency in circulation	46.7	40.2	38.7	8.0	20.8
Demand deposits	158.6	137.1	135.1	23.5	17.4
Savings and Term deposits*	218.9	202.4	193.5	25.4	13.1
<i>equals</i>					
Net foreign assets	302.4	266.7	275.2	27.2	9.9
<i>plus</i>					
Net domestic assets	121.8	113.0	92.1	29.7	32.3
Gross bank lending**	318.5	305.6	287.8	30.7	10.7
Other***	-196.7	-192.5	-195.7	-0.9	0.5

* Also includes very minor amounts for securities other than shares.

** Differs slightly from standard measures of bank lending by amounts classified as accrued interest.

*** Includes mostly the banks' and NRBT's capital accounts, and their net claims on the central government.

Sources: Banking System; NRBT

Table 4: Lending Rates

Weighted average of all banks

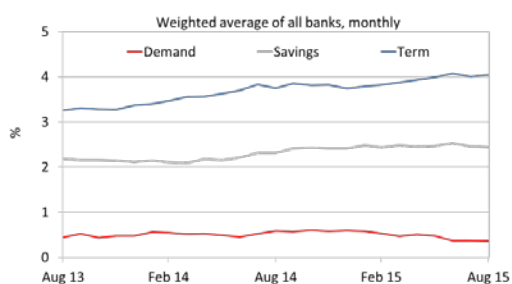
	Level as at			Change over 6 month to:		Loan share	
	Aug 15 % p.a.	Feb 15 % p.a.	Aug 14 %	Aug 15 bps	Feb-15 bps	Aug 15 %	Aug 14 %
All	8.29	8.46	8.62	-17	-16	100	100
Housing	8.58	8.47	8.60	11	-13	35	35
Other personal	11.02	11.04	11.22	-2	-18	18	18
Business*	7.40	7.77	8.09	-37	-32	26	26
Other	6.38	6.53	7.83	-15	-130	21	21

*Included Statutory Non-financial Corporation and Other Financial Corporations

Source: Banking System

The weighted average interest rate on all bank loans fell by 32.7 basis points over the year to August 2015, due mainly to banks offering competitive interest rates on loans mostly to public enterprises and prime customers. The weighted average interest rates on most of the key bank lending categories fell over the six months to August 2015, with the business category declining the fastest. The decline in businesses' weighted average lending rate supported a 12.2% increases in business loans over the same period. However, the weighted average interest rates for household loans increased by 3.1%, reflecting a rise in lending rates for housing and vehicle loans.

Figure 16: Deposit Rates



Source: Banking System

On the other hand, a rise in savings and term deposits rates drove the 2.4 basis points annual increase in weighted average deposit rates. Meanwhile, over the six months to August 2015, the weighted average interest rates on most of the key bank deposit categories fell, with the demand deposit category declining the fastest. Conversely, the weighted average interest rate on term deposit

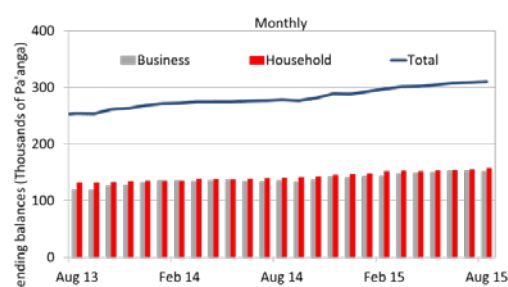
increased which is indicative of banks building up their deposit base to fund the expansion of their loan books.

Lending

Banks' total lending increased over the year to August by 11.5% to \$310 million, which is higher than the 9.4% growth over the year ended February 2015. This is the highest growth recorded in the last 5 years, suggesting growing economic activities in the Kingdom. The growth in loans resulted from increased lending to businesses and households.

However, annual total loans extended by banks and non-banks rose by only 8.5%, reflecting lower on-lent loans by the government.

Figure 17: Bank's lending

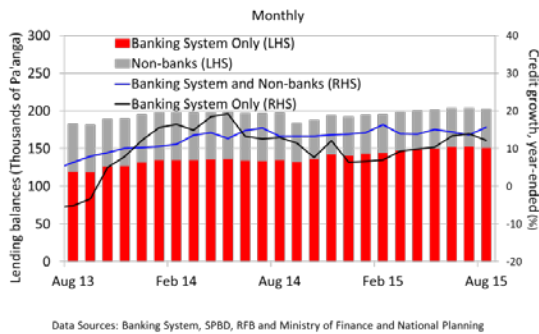


Source: Banking System

Business lending increased over the year by 12.2% to \$151.2 million, due mainly to a rise in lending to public enterprises, the manufacturing, agricultural and distribution sectors. This growth is partially supported by the Government's managed funds scheme that is facilitated by the Tonga Development Bank. The increase in business outstanding loans

coincides with lower weighted average interest rate for business loans over the year. However, new business loan commitments fell over the year to August 2015 particularly for construction and professional & other services sectors however consultation with banks have indicated some anticipated pipeline bankable projects, which may reverse this lower trend for new business loan commitments.

Figure 18: Business Lending

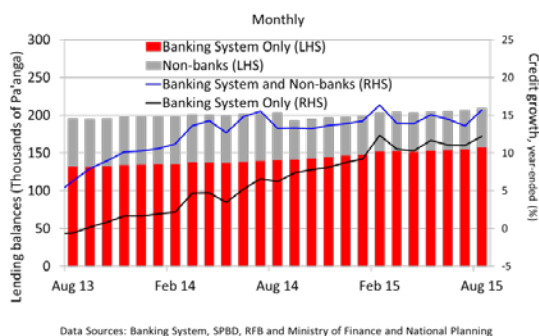


Lending to households also rose over the year by 12.2%, resulting mainly from an increase in housing and other personal loans. This supports growth in import payments for construction materials and wholesale & retail goods.

New household loan commitments increased significantly over the year ended August 2015 to about \$7.2 million. This was driven mainly by the rise in housing and other personal loan commitments.

After adjusting for the non-bank lending programs, year-ended growth in household loans would have risen by 15.7%, reflecting an increase in South Pacific Business Development and Retirement Fund lending activities.

Figure 19: Household Lending



Banking System Performance

Tonga's banking system continued to remain sound in the six months to August 2015. The total assets of the financial system increased by 7.9% to \$620.5 million over the six months to August 2015 mainly due to growth in total loans and the higher Exchange Settlement Accounts, which coincides with the higher broad money. Similarly, total liabilities increased by 8.9% to \$480 million, due mainly to a 9.6% growth in total deposits over the six months to August 2015. In contrast, total provisions slightly fell by \$0.4 million (2%), reflecting loan loss provisions written back due to loans being upgraded to performing status since February 2015. This indicates an improvement in the performance of private sector businesses and improved economic conditions.

The profitability of the total banking system continued to improve over the six months ended August 2015 which was attributed mainly to improvement in non-interest income and interest income by 9.4% and 6% respectively. Return on assets and return on equity have increased accordingly to 3.1% and 10.1% respectively in August 2015, compared with 2.6% and 8.4% respectively in February 2015. The liquidity position of the banking system continued to strengthen and remain comfortably above the minimum requirement during the six months to August 2015. Furthermore, the capital position of the banking system remained strong as healthy profits were recorded by the banks. The total risk-weighted capital ratio remained above the minimum ratio required by the NRBT of 15% at 38.8% at the end of August 2015.

The overall quality of the banks' assets (loan portfolio) still requires close monitoring over the six months to August 2015 even though there was some improvement to a more manageable level compared to previous years.

Total non-performing loans decreased by 1.7% to \$27.5 million over the six months to August 2015, representing 8.9% of total loans, improving from 9.4% six months ago. There are adequate provisions held against the non-performing loans.

Outlook

In line with the IMF forecast, the NRBT forecasts broad money to increase by about 5% in the 2015/16 financial year. This is due mainly to an expected pickup in foreign reserves and domestic credit. Currency in circulation is also expected to rise resulting from high demand for the new currency that was launched in July 2015 and improved domestic economic activities, which will be partially offset by the recall of the old currency.

Credit growth is supported by the continuous improvements in business confidence and lending conditions. Continued competition amongst banks and the ongoing lending

activities of the Government's manage funds will continue to support the current low lending rates.

The NRBT is forecasting credit to grow by more than 10% in the next six months. This is based on continuous improvements in business confidence; imminent drawdowns of some large loan commitments; the continued low interest rates; and the Government's manage funds loan scheme. Commercial banks' prospects for credit growth remain positive. The NRBT will continue to promote prudent lending and closely monitor credit growth in light of the impact on the monetary policy targets and financial stability.

6. Fiscal Indicators

Since the February 2015 MPS, the Government's 2015/16 budget has been released. This supports the IMF 2015 Article IV report which stated that Tonga's fiscal position has improved supported by large grant inflows. However, spending pressures for government remain high in the near term.

Data collected by the NRBT shows net credit to government increased by 11% in the six months to August 2015, after declining by 5% in the six months to February 2015, and compared to a 21% increase in the same period of last year. This is due to a decline in government deposits which reflects the settlement of government commitments and payment obligations before the end of the fiscal year. Government payments abroad also rose by 18.0%. Nonetheless, government receipts from abroad rose by over 60% in the six months to August 2015 largely due to receipts of budgetary support and other donor related projects of over \$20 million.

Over the year ended August 2015, net credit to government rose by about 6%, also underpinned by a fall in government deposits.

Going forward, it is anticipated that government receipts will increase in the near term from budget support and issuance of government bonds. These are to finance the overall net borrowing requirement of \$20.7 million for the 2015/16 fiscal year, as reflected in the Ministry of Finance and National Planning's 2015/16 Budget Statement.

The anticipated government bond issue of \$15 million during 2015/16 is to support the government's managed fund loan scheme facilitated by the Tonga Development Bank and settle government's arrears on the civil servants' retirement fund. This would also contribute to a rise in public debt, which currently accounts for 51.3% of GDP. The bond issue provides investment opportunities for local investors therefore, supports the NRBT not underwriting the bond issue. This would utilize the excess liquidity in the banking system.

In addition, government receipts are expected to increase as new Government revenue streams have been established to assist the funding of the South Pacific Games to be hosted in 2019. This includes increasing the departure tax and re-introducing of the Foreign Exchange Transaction Levy. This also may pose risks to the developments in domestic economic activities.

Net credit to government is also expected to increase, resulting in an increase in liquidity within the banking system and broad money. With the anticipated budget support receipts and no budgeted foreign debt, although 50% of the budget support would be concessional loans to be repaid in later periods, this supports the forecasted foreign reserves to remain above 3–4 months of imports over the next year. NRBT will closely monitor the implication of the fiscal policy measures on the monetary policy objectives.

7. Monetary Policy Stance

The NRBT's monetary policy target is to maintain adequate level of foreign reserves above 3-4 months of import cover and to promote low and stable inflation below 6% annually.

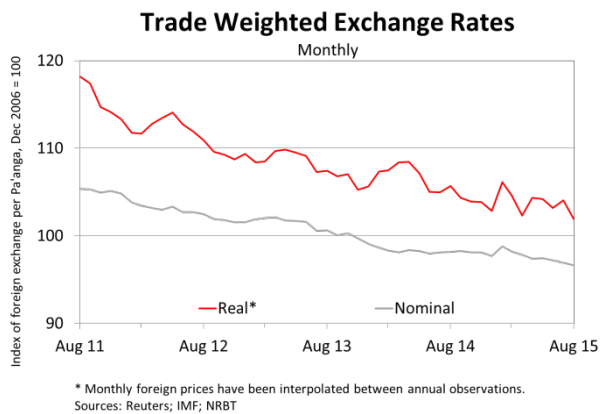
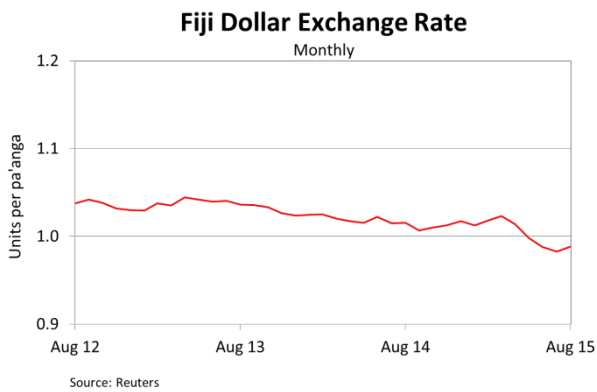
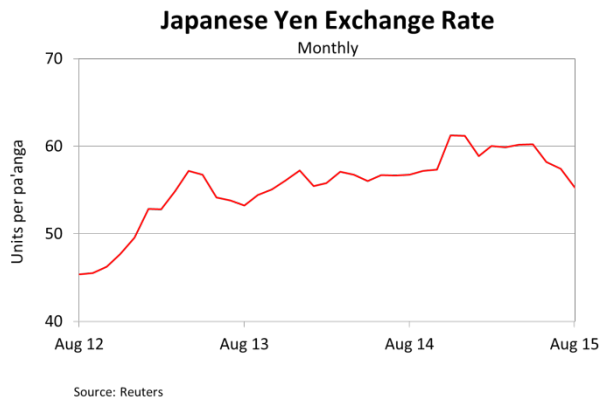
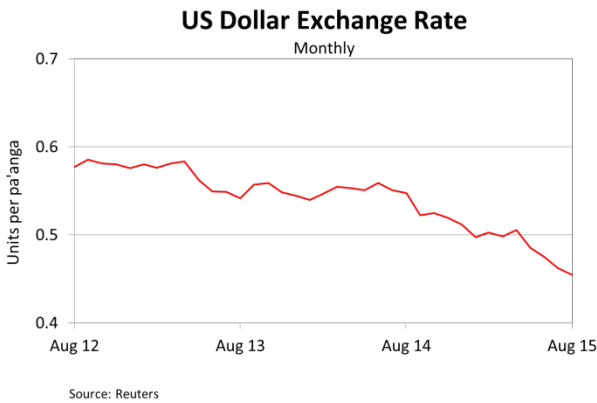
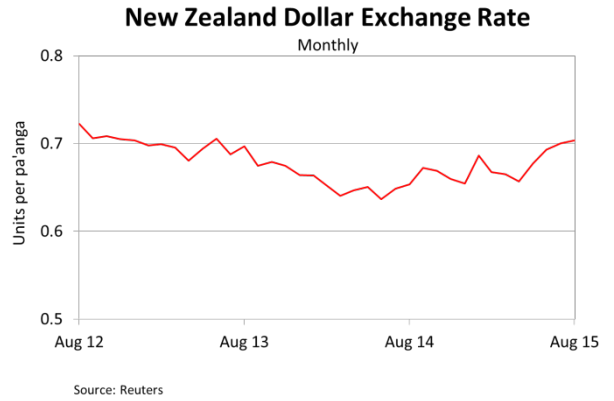
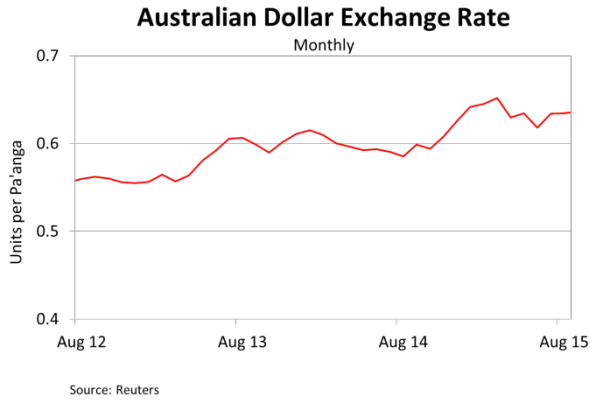
Against the background of low inflation, high foreign reserves, stable and competitive exchange rates, improving monetary conditions with high liquidity, improving credit and deposit growth and narrowing interest rate spreads, the NRBT maintained its accommodative monetary policy stance in the past six months to continue to support macroeconomic stability and economic growth.

Given the recent developments in the major trading partners' economies coupled with the continued lower world oil prices, the NRBT's outlook for Tonga's economy remains positive. Early signs of improvement are evident from

the agricultural sector. We also expect robust credit growth as business confidence and conditions improve. The banking system continued to remain relatively stable and profitable, with reported credit growth and strong liquidity and capital positions. Low inflationary and liquidity pressures together with ample foreign reserves support no change to the current monetary policy settings in the near term.

The NRBT will continue to promote prudent lending, closely monitor credit growth and be mindful of the impact of a continued deflation. The NRBT will closely monitor the country's economic and fiscal developments and financial conditions to maintain internal and external monetary stability, and promote a sound and efficient financial system to support macroeconomic stability and economic growth.

Appendix 1: Tongan Pa'anga Exchange Rates



Appendix 2: Monetary Policy Objectives

The NRBT's obligations with respect to monetary policy are laid out in Section 4(1) of the National Reserve Bank of Tonga (Amendment) Act 2014, which state that the principal objectives of the Bank shall be to:

- 1) maintain internal and external monetary stability.
- 2) without prejudice to its principal objective, the Bank shall-
 - (a) promote financial stability; and
 - (b) promote a sound and efficient financial system.
- 3) subject to subsections (1) and (2), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth.

In addition, Section 30(2) of the NRBT (Amendment) Act, states the Bank shall exclusively hold and manage the official international reserves of the Kingdom and maintaining an adequate level of foreign exchange reserves.

Under the Act, the NRBT shall maintain internal and external monetary stability through maintaining official foreign exchange reserves and promoting price stability.

Maintaining an adequate level of foreign reserves is vital for a small open economy such as Tonga. It is dependent on imports for the supply of most of its goods, which needs to be paid for in foreign currency. Given Tonga's vulnerability to external shocks and natural disasters, its small size, narrow export base, and dependence on imports, it is imperative that foreign reserves are maintained at an adequate level to meet individuals' needs for basic essentials and support economic growth.

An adequate level of foreign reserves also minimizes volatility in the exchange rate and provides confidence that businesses and

individuals in Tonga are able to meet their foreign currency obligations. The Reserve Bank targets a level of foreign reserves equivalent to 3 to 4 months of imports.

Imported goods account for 58% of the CPI basket, so changes in the prices of imported goods and the exchange rate have a significant influence on the overall level of domestic prices.

Price stability contributes to economic welfare and sustainable economic development. Price stability also contributes to better economic performance. When inflation is low and stable it is easier for people to distinguish changes in relative prices and to adjust their decisions regarding consumption, saving, and investment accordingly. Importantly, an environment of stable prices also reduces risk in long-term financial agreements, as lenders and investors will be less likely to demand a high inflation risk premium to compensate for the loss of purchasing power. This reduces the costs to borrowers and increases the incentives for businesses to invest.

The high proportion of Tonga's exports and imports as a share of production means that domestic prices are likely to move closely with the prices of traded goods, which in turn depend closely on the value of the exchange rate. Vulnerability to external shocks, such as oil price increases, adverse weather conditions, and high dependence on remittances and imports, heighten the importance of promoting external stability, exchange rate stability and therefore overall price stability.

By promoting external stability through maintaining an adequate level of foreign reserves and promoting price stability, the NRBT through its conduct of monetary policy can most effectively contribute towards macroeconomic stability, sustained economic growth and raising prosperity for Tonga.